BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
NIPPONDENSO OF LOS ANGELES, INC.)

For Appellant: Joel M. Butler
Attorney at Law

For Respondent: Michael E. Brownell
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Nippondenso of Los Angeles, Inc., against proposed assessments of additional franchise tax in the amounts of $20,437, $23,535, $25,349, and $10,512 for the income years 1972, 1972, 1973, and 1974, respectively.

Nippondenso of Los Angeles, Inc.

The question presented by this appeal is whether or not appellant was engaged in a single unitary business with its parent corporation, Nippondenso- Co., Ltd. (NDJ), during the appeal years.

Appellant is a California corporation incorporated. in 1971. It was 75% owned by NDJ and 25% owned by Toyota Motors U.S.A., Inc. (Toyota U.S.A.). NDJ, a Japanese corporation, was formed in 1949 in a reorganization of the electrical and radiator departments of Toyota Motors Co., Ltd. (Toyota). NDJ now is an integrated manufacturer of a full line of automotive parts, principally electrical and electronic components, but including injection pumps, radiators, filters, spark plugs, and emission control and safety components. Air conditioning units make up the largest single item of sales. NDJ's principal Japanese customers are Toyota, Honda Motor Co., Ltd., Suzuki Motor Co., Ltd., Kawasaki Heavy Industries, Ltd., and Yamaha Motor Co., Ltd.

Appellant's principal business activity is importing, assembling, and wholesaling automotive parts and accessories. Most of the products which it sold during the appeal years were made by its 75% parent, NDJ (1972 - 88.7%; 1973 - 88.3%; 1974 - 76.9%). Appellant made approximately 80% of its sales to Toyota U.S.A., its 25% owner. Remaining sales were to other automobile dealers and distributors.

Appellant's president during 1971 and 1972 was also the president of an NDJ subsidiary in Japan. Two of appellant's five directors were concurrently officers or directors of NDJ, although appellant states that they were not physically present in the United States, Two of the remaining three directors (who were also executive officers of appellant) had been transferred from NDJ or another NDJ subsidiary during. appellant's incorporation.

From April 2, 1971, to March 31, 1974, appellant and NDJ had a licensing agreement whereby appellant had the right to use NDJ's patents and technical data necessary for the manufacture or assembly and sale of motor vehicle air conditioners in the United States. Under the agreement, NDJ was to provide any necessary technical assistance or training. Royalties were to be paid for each air conditioner sold. by appellant during the first licensing period of April 2, 1971, through December 31, 1971. Appellant accrued on its books approximately $41,408 to cover the royalties for that period. Thereafter, the royalty was to be paid only on air conditioning units sold by appellant in excess of 25,000 units during each calendar year. No royalties were paid in 1972 because less than 25,000 units were sold in that year. Appellant's initial activity after incorporation was apparently the assembly of air conditioning kits, pursuant to this licensing agreement, for sale and installation in Japanese cars sold in the United States.

Although appellant conducts its own advertising and promotion, in 1972 NDJ paid appellant $102,175 as an "advertising allowance" used to promote the merchandise manufactured by NDJ. Appellant states that this was an extraordinary payment rather than a regular one.

Financing, purchasing, accounting, personnel, retirement plans, legal counsel, and insurance were apparently separately handled by appellant during the appeal years. Appellant states that it was not involved in research and development of automobile parts and processes during these years, so there was no need for technical assistance from NDJ.

For each of the years on appeal, appellant filed a separate California franchise tax return. Upon audit, respondent determined that apellant and NDJ were engaged in a single unitary business. Therefore, appellant's California income was redetermined using combined report and apportionment procedures. This appeal followed respondent's affirmation of the resulting proposed assessments.

When a taxpayer derives income from sources both within and without this state, its franchise tax liability is measured by its net income derived from or attributable to sources within this state. (Rev, & Tax. Code, § 25101.) If the taxpayer is engaged in a single unitary business with affiliated corporations, the income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 161 (1947).)

The existence of a unitary business may be established under either of two tests set forth by the California Supreme Court. In Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942), the court held that a unitary business was definitely established by the presence of unity of ownership, unity of operation as evidenced by central purchasing, advertising, accounting, and management divisions, and unity of use in a centralized executive force and general system of operation. Later, the court stated that a business is unitary if the operation of the portion of the business done within California is dependent upon or contributes to the operation of the business outside California. (Edison California Stores, Inc. v. McColgan, supra, 30 Cal.2d at 481.)

Respondent's determination is presumptively correct and appellant bears the burden of proving that 'it is incorrect. (Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) Each appeal must be decided on its own particular facts and no one factor is controlling,. (Container Corp. of America, v. Franchise Tax Bd., 117 Cal.App.3d 988 [173 Cal.Rptr. 121] (1981), affd., -- U.S. -- [77 L.Ed.2d 5453 (1983).) Where, as here, the appellant is contesting respondent's determination of unity, it must prove by a preponderance of the evidence that, in the aggregate, the unitary connections relied on by respondent were so lacking in substance as to compel the conclusion that a single integrated economic enterprise did not exist.

Appellant concedes that unity'of ownership was present since NDJ owned 75% of appellant's stock. It contends, however, that the remaining connections between NDJ and appellant were insufficient to support a finding of either the unities of use and operation or contribution or dependency between the two corporations.

We must disagree with appellant since we find that sufficient contribution and dependency existed between appellant and NDJ to demonstrate that the two companies were engaged in a single unitary business during the appeal years. In spite of appellant's emphasis on its autonomy from NDJ, we find a number of connections between the two companies which indicate that they were sufficiently linked to be considered parts of a single economic enterprise for purposes of taxation.

Foremost among those connections was the substantial product flow from NDJ to appellant. Intercompany product flow is an important element of contribution or dependency. (Appeal of Beecham, Inc., Cal. St. Bd. of Equal., March 2, 1977.) Appellant contends that this was not significant because the product flow was one way and because the sales are made at arms-length prices. While the product flow was one way, the "flow of value" (Container Corp. of America'v. Franchise Tax Bd., supra,

-- U.S. at --) goes both ways: appellant receives the products and NDJ has a significant market distributor for non-factory-installed automotive parts. Even if the sales were proven to be at arms-length prices, this would not make the sales less significant as a unitary indicator. (Appeal of Arkla Industries, Inc., Cal. St. Bd. of Equal., Aug. 16, 1977.)

Appellant is correct in pointing out that intercompany product flow alone is insufficient to support a finding of unity. (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal.App.3d 496, 506 [87 Cal.Rptr. 239], app. dism. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (1970).) However, even while rejecting a substantial flow of goods as a "bright-line rule" for determining unity, the United States Supreme Court has reaffirmed that a substantial flow of goods is clearly one of the ways in which substantial mutual interdependency can arise, even though not the only one. (Container Corp. of America v. Franchise Tax Bd., supra, -- U.S. at --.) We believe that this substantial flow of goods from the manufacturing parent to the distributing subsidiary is a clear demonstration of classic vertical integration and contribution and interdependency.

Interlocking directors and officers, frequently strong indicators of unity, were also present during the appeal years. Appellant denigrates the significance of appellant's two directors who were also directors or officers of NDJ. However, we note that the actions of appellant's board of directors were apparently always accomplished by unanimous written consent, requiring the signatures of these two foreign-based directors, rather than by the majority action of the three resident directors in Los Angeles. As for appellant's allegations that the board took actions contrary to the best interests of NDJ individually, even if that were proven, we would not necessarily consider it a detraction from unity, since what might be adverse to the interests of one segment of a unitary business might well benefit the enterprise as a whole such that the individual detriment would be entirely offset. The significance of two interlocking directors is bolstered by the fact that two more of the five directors were originally from NDJ or one of its subsidiaries. Therefore, four-fifths of the directors had direct ties with NDJ and, apparently, brought some beneficial expertise with them; otherwise, truly independent directors could have been elected. Some contribution, therefore, must have been made to both NDJ and appellant from having directors with ties to NDJ.

Other circumstances pointing toward contribution or dependency between appellant and NDJ are the license agreement which provided for sharing technical expertise, the substantial contribution made in 1972 by NDJ to appellant for advertising NDJ's products, and the use of a common trade name and logo. Appellant argues that each of these circumstances lack's significance for a variety of reasons. We certainly agree with appellant that none of these factors is necessarily significant in and of itself, but we find that, taken together with the highly significant product flow and integration of executive forces, they create a convincing picture of a unitary business which appellant has failed to dispel. The interrelationships between the two companies are apparent and substantial, making the elements of independence and separateness emphasized by appellant appear inconsequential. We must conclude, therefore, that respondent's determination of unity was correct.

Nippondenso of Los Angeles, Inc.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Nippondenso of Los Angeles, Inc. against proposed assessments of additional franchise tax in the amounts of $20,437, $23,535, $25,349, and $10,512 for the income years 1972, 1972, 1973, and 1974, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 12th day of September , 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenbung, Mr. Collis and Mr. Bennett present.

Riehard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

_______________, Member